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Intelligence**

The Chinese Economy in 1989 and 1990: Trying To Revive Growth While Maintaining Social Stability

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July 1990**

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The Chinese Economy in 1989 and 1990: Trying To Revive Growth While Maintaining Social Stability

This paper was prepared by the Central Intelligence Agency for submission to the Subcommittee on Technology and National Security of the Joint Economic Committee, Congress of the United States.

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*EA 90-10023
July 1990*

The Chinese Economy in 1989 and 1990: Trying To Revive Growth While Maintaining Social Stability

Summary

*Information available
as of 25 June 1990
was used in this report.*

Beijing is grappling with the fallout from overly restrictive austerity policies implemented in late 1988, which dampened inflation in urban areas from almost 30-percent annual rates to single digits, but which also caused China's worst economic slump in a decade. In 1989, real GNP grew less than 4 percent, about one-third the rate posted a year earlier, according to Chinese statistics. Weak industrial growth hurt enterprise profitability and increased price and enterprise subsidies, which expanded the government's budget deficit by about 40 percent to a record \$8 billion.

Growing unemployment—which has reached its highest level in a decade—and falling urban living standards are undermining Beijing's efforts to reestablish the country's social stability, which remains tenuous a year following the government's suppression of the prodemocracy demonstrations. Consequently, Beijing has begun to ease austerity modestly—increasing credit to large state firms, loosening restrictions on capital construction, and lowering interest rates on bank loans—to head off labor discontent. The recent infusions of credit, however, have been slow to stimulate demand or revive industrial production. During the first five months of this year, industrial production remained sluggish, increasing at less than a 2-percent annual rate. Moreover, fundamental indicators point to continued weaknesses in the economy—inventories continue to accumulate, the growth rate of the once vibrant rural industrial sector has dropped sharply, and the production of large state-run enterprises remains sluggish.

To keep inflation from reemerging as it increases credit, Beijing is turning to administrative measures. Broader central controls, however, will reduce incentives for increased efficiency by curtailing managerial autonomy and increasing the share of goods sold at low, state-set prices. Increased government allocations of raw material and energy inputs to large state enterprises will drain resources from China's dynamic nonstate sector and lower its integral contribution to economic growth. Moreover, if Beijing's intensified support to large state enterprises fails to revive the economy, political pressures may force Beijing to open the credit spigot wider, renewing the inflationary pressures the government was originally so determined to squelch.

Beijing's renewed preference for administrative controls is also visible in China's foreign economic relations, as the central government has reclaimed much of the foreign trade authority it devolved to the lower levels

under reforms in the late 1980s. Tightened central controls over the trade sector have helped Beijing prevent a rapid drawdown of foreign exchange reserves. As a result, China narrowed its trade deficit last year by \$1.1 billion to \$6.6 billion, according to Chinese Customs statistics. In the first four months of this year, China posted a trade surplus of \$1.3 billion.

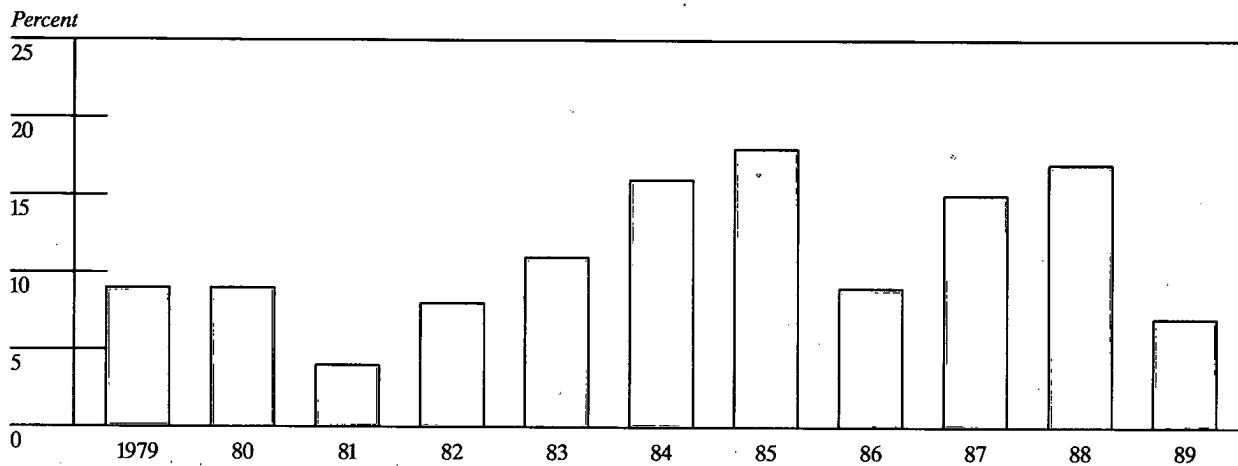
The leadership's focus on maintaining party control by using administrative measures to treat the symptoms of China's economic ills makes prospects for return in the near term to comprehensive, market-oriented reform dim. Economic policy will probably remain dominated by stopgap measures aimed at ensuring social stability, precluding riskier, longer term strategies for growth and development. Although it is unlikely that many senior officials want to return to the command economy and isolationist policies that dominated China before 1979, some in the leadership want to place strict limits on the development of the nonstate sector and to increase the party's role in enterprise management.

Failure to proceed with comprehensive market-oriented reforms will eventually dampen the performance of the economy by curbing productivity gains. The hold on market reform could slow lending by international financial institutions, even if Western economic sanctions are lifted. This could delay progress on China's long-term modernization goals as decreased access to low-cost financing impairs its ability to gain technological know-how through high-tech joint ventures or to import advanced technology. A continued decline in capital goods and raw material imports will also stifle the pace of China's economic development. Beijing's inability to proceed with reforms will also widen the economic gulf between China and its market-oriented East Asian neighbors.

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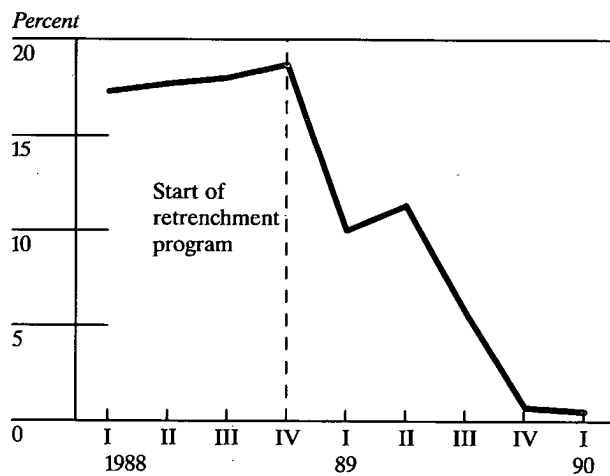
Figure 1
Growth of Industrial Output



Source: Official Chinese statistics

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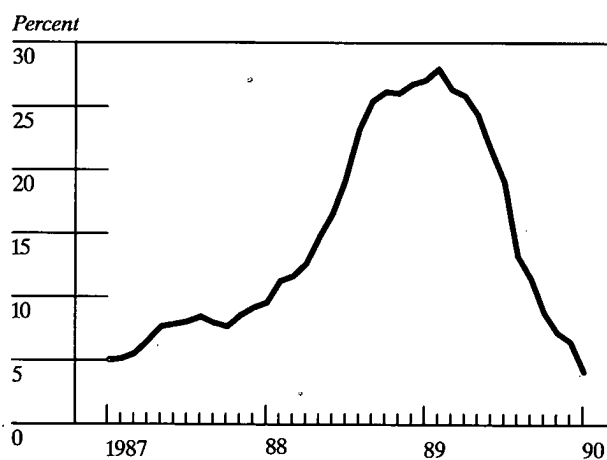
Figure 2
Industrial Growth, Quarterly



Source: Official Chinese statistics

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Figure 3
Inflation



Source: Official Chinese statistics

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The Chinese Economy in 1989 and 1990: Trying To Revive Growth While Maintaining Social Stability

Curbing Runaway Growth

The economic austerity program the Chinese leadership began implementing in late 1988 has sharply applied the brakes to the country's overheated economy. According to Chinese statistics, real GNP grew less than 4 percent last year, about one-third the rate in 1988, while the industrial growth rate fell from 17 to 7 percent.¹ Last October, industrial output actually contracted—for the first time in a decade; it grew at less than a 1-percent annual rate in the fourth quarter of 1989 and the first quarter of this year. Beijing's austerity policies accordingly brought inflation down from a 27-percent annual rate in January 1989 to a 6-percent annual rate at yearend. (See appendix A for a detailed review by sector of economic performance in 1989.)

Beijing turned to administrative measures to cool inflation when it began implementing its austerity program in September 1988. These included sharp cutbacks in investment projects, tight quotas on bank credit, reimposition of price controls on many industrial goods, and a cessation of further experiments with market measures. Beijing has used this approach because reforms begun a decade earlier have not progressed far enough to enable it to employ indirect economic levers, such as monetary and fiscal policies, to control the overall demand for goods. Indeed, because early reforms succeeded primarily in delegating economic authority to local governments rather than creating markets and financial accountability, Beijing can apply what monetary and fiscal levers it has only with the help of local officials, who are concerned with speeding development of their own economies and boosting local standards of living.

¹ Most figures cited in this paper are official Chinese statistics. We report them because they provide useful indications of the direction and magnitude of economic growth even though collection techniques are inexact and local officials sometimes deliberately distort data. For a detailed discussion of the problems involved in using Chinese data and ways to circumvent them, see EA 89-10023 (August 1989), *The Chinese Economy in 1988 and 1989: Reforms on Hold, Economic Problems Mount*, report to the Joint Economic Committee of Congress.

Beijing's Austerity Program

Beijing began implementing an austerity program in September 1988 to slow urban inflation, which had reached a 40-year high of about 30 percent at an annual rate. Key market reforms, such as price decontrol, were put on hold, and measures designed to slow capital construction, restrict spending, and control prices were instituted. These included:

- *Reduced state investment. Beijing cut state investment spending by 9 percent in 1989.*
 - *Restricted credit. Beijing tightened credit ceilings for domestic banks and raised interest rates on bank loans to discourage bank-financed investment outside the state plan. The government raised interest rates on household deposits and imposed limits on the amounts individuals could withdraw from savings accounts. Officials also called for a halt in loans to private and rural enterprises.*
 - *Reduced foreign borrowing. Beijing reduced from 100 to only 10 the number of government entities authorized to borrow funds abroad to slow the flow of credit acquired through foreign channels.*
 - *Tightened price controls. Beijing reimposed price controls for steel, copper, aluminum, and other production materials.*
 - *Expanded raw material controls. The central government reestablished its monopoly over the distribution of fertilizer, pesticides, and plastic sheeting to control speculation on farm inputs.*
 - *Tightened foreign trade controls. The number of corporations authorized to import certain products was reduced, imports of selected consumer goods and industrial inputs were banned, and control over the use of foreign exchange was tightened. On the export side, the number of products subject to licenses, quotas, or outright bans was expanded.*
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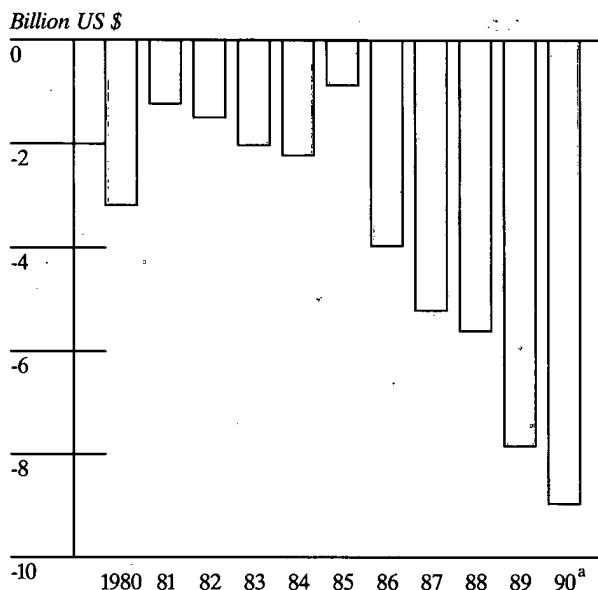
Although successful in slowing inflation, austerity-mandated cutbacks in bank credit have created massive debt defaults among enterprises, depressing demand and causing inventories to soar; stockpiles of finished goods were two-thirds above normal in April. Government incentives to increase personal savings, such as inflation-indexed bank rates, added to the inventory problem by pushing savings deposits up 35 percent to a record \$109 billion at yearend 1989, which contributed to an almost 8-percent real decrease in retail sales.

Weak industrial growth prevented government revenues from keeping pace with increased subsidies to financially ailing state enterprises and workers. Thus Beijing's budget deficit increased about 40 percent to a record \$8 billion in 1989. Growing inventories and lagging labor productivity—per capita productivity increased only 1.6 percent last year—contributed to rising production costs. According to Chinese statistics, more than 6,200 enterprises recorded losses—more than double the level in 1988—and profits of state-owned enterprises dropped nearly one-fifth.

Economic Problems Threaten Social Stability

Austerity measures are also responsible for rising unemployment and falling urban living standards; these have undermined Beijing's efforts to restore China's social stability, which remains tenuous a year after the government's suppression of the prodemocracy demonstrations. In the last six months of 1989, according to a Hong Kong press report, more than 600 instances of worker unrest occurred, including slowdowns, demonstrations, rallies, and strikes. According to many accounts, layoffs have created an embittered and volatile class of unemployed. Workers are disgruntled because they believe they are bearing the brunt of Beijing's austerity measures; many are receiving only about 70 percent of their expected wages and no bonuses, which have traditionally accounted for about one-third of workers' incomes. Some factories, facing severe cash shortages and overstocked inventories, are struggling to find ways to pay workers; in one extreme case, a consumer durables factory in Guangzhou was forced to put workers on halftime late last year and pay them in kind—with

Figure 4
Budget Deficit



^aProjected.

US \$1 = 4.72 yuan.

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refrigerators. In other parts of China, factories have supplemented workers' reduced wages with products bartered with other cash-strapped factories. Some workers have complained that the current belt-tightening is the worst they have experienced since the early 1960s, when China was recovering from the disastrous Great Leap Forward.

Accordingly, for the second consecutive year, real wages for workers fell in 1989 as inflation outpaced wage increases. The cut in real wages was exacerbated by Beijing's requirement that factory workers spend a portion of their income to purchase treasury bonds to help cover the country's bulging budget

deficit. This two-year decline in living standards contrasts sharply with the remarkable improvements achieved between 1978 and 1987, when real income grew more than 7 percent yearly.

Nearly two-thirds of urban factories were closed or operating below capacity at yearend 1989, according to the Hong Kong press, idling millions of workers and pushing urban unemployment to its highest level in a decade. In addition, the austerity program hit China's rural enterprises hard. Beijing blamed these firms for diverting scarce raw materials from state enterprises, contributing to inflation, breeding corruption, and wasting resources. Beijing cited the need for austerity to sharply reduce supplies of credit and raw materials to locally run factories. As a result, more than a million locally run enterprises, primarily in the countryside, shut down last year, and 3.5 million workers were laid off.

Burdened by one-third more workers than required to work the land, the agricultural sector has had to absorb millions of laid-off rural enterprise workers and thousands of migrants who have been sent home from the cities in the last six months. Millions of construction workers are also returning to the countryside now that restricted credit has brought an abrupt end to the country's decadelong construction boom, which had doubled the size of China's construction work force. Many of these newly unemployed workers probably will join the "floating population" of itinerant workers, which averages between 60-80 million, according to official statistics.

To keep unemployed rural workers from returning to urban areas in search of jobs, Beijing is reinforcing the labor permit system and making factories that employ nonregistered workers pay stiff fines. Several coastal cities have also tightened residency requirements that qualify citizens for food ration coupons. Moreover, during the Lunar New Year holiday in January—a period of traditionally high rural-urban migration—municipal police patrolled urban train stations to turn back rural workers.

The growing number of unemployed and underemployed poses a social problem whether they return to the countryside or stay in the cities. In addition to

disturbances in the workplace, the growing pool of idle workers has produced a rise in the level of crime nationwide. Municipal and provincial measures to deal with rising crime have increased pressure on local budgets, already strained by the burden of providing health care, housing, and essential commodities for those without jobs.

The leadership is clearly concerned with widespread alienation; the party plenum that concluded in March emphasized strengthening party ties to the public to enhance social control and reduce discontent. The plenum communique urged the party to "make every effort to restore and develop the party's fine tradition and work style of maintaining close ties to the masses."

Recent Policy Initiatives

Backing Away From Austerity . . .

Beijing has begun to ease austerity modestly to head off further labor discontent. Late last year Beijing injected the equivalent of \$25 billion of new credit into the economy, approximately \$5 billion above the annual credit ceiling set for 1989. In addition, the central bank earmarked nearly \$12 billion in loans to industrial and commercial enterprises for the first half of this year, nearly twice the original target. Moreover, in mid-March, Beijing lowered interest rates on bank loans.

This infusion of credit has been slow to stimulate demand or revive industrial production.² One reason may be that a large share of the credit infusion has been absorbed in making overdue payments on the huge factory inventories rather than contributing to new production. State enterprises that have benefited from this increase in credit may also be hoarding the

² The marked absence of stimulative demand stemming from this injection of credit is suggested by the less than 3-percent increase in money in circulation in the first quarter of this year compared with the same period a year earlier. This is drastically lower than the yearend 1989 currency growth rate of 10 percent and the first-quarter 1989 growth rate of 45 percent.

new funds. Some Chinese press accounts have indicated that the new credit represents only an acceleration of planned annual credit disbursements rather than an increase in the annual target; enterprises may be reserving funds in anticipation of a return to more restrictive credit policies later this year, when liquidity needs are traditionally the highest.

To spur consumer demand—retail sales continued their slump during the first four months of this year—Beijing reduced interest rates on savings deposits in mid-April. Beijing has also recently reduced the prices of some consumer durables—including color televisions, refrigerators, washing machines, and electrical appliances—and authorized accelerated purchases by state units of selected products, for example, the replacement of official automobiles a year ahead of schedule.

To mollify urban workers, Beijing has increased price subsidies and food supplies. Pay raises were also recently ordered for all state employees. But wage increases are being constrained by the same factors that currently prevent many enterprises from paying full wages and bonuses—insufficient liquidity, growing debt, inadequate access to credit, poor production prospects, and expanding budget deficits.

Beijing's concern about the potential for unrest in the countryside was reflected in a \$5 billion increase in credit by the central bank last fall, which enabled local officials to pay peasants for grain in cash rather than with IOUs—as they did in 1988. In the past, issuance of IOUs for grain has resulted in peasants' refusal to fulfill their state grain contracts; some local officials have retaliated by refusing to register workers' children for school or by confiscating personal possessions.

... Fine-Tuning Central Planning ...

To keep inflation from reemerging as it eases credit, Beijing is continuing measures begun last year to recentralize management of state enterprises, prices, and investment. Moreover, to bolster the state sector, Beijing is directing increases in bank credit to selected large state enterprises operating under central plans and is continuing to restrict access to credit for private and locally run firms.

To strengthen the central government's control over the economy, late last year Beijing announced the formation of the Production Commission under the State Planning Commission to coordinate industrial output. Serving many of the functions of the State Economic Commission disbanded in late 1987 by then General Secretary Zhao Ziyang, the Production Commission is responsible for allocating capital, raw materials, transportation, and energy to China's industrial sector. As part of this effort, the Production Commission earlier this year designated more than 200 key industrial enterprises part of a new "double guarantee" program, under which the state guarantees all the necessary inputs in return for a contracted level of taxes, profits, and output. Beijing is thus trying to increase the share of resources and finished goods under its administrative control.

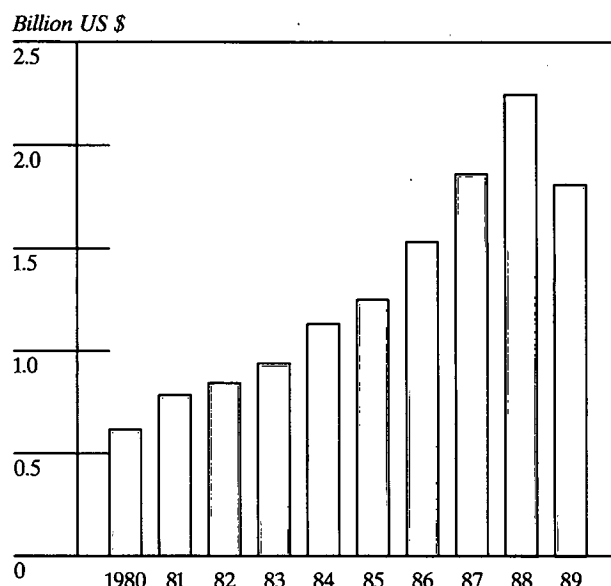
Beijing strengthened its economic grip in April over the coal industry, tightening control over coal prices to dampen profiteering based on the gap between in-plan and out-of-plan prices. For the same reason, Beijing increased centralized allocation of caustic soda and rare metals. Beijing has also significantly recentralized the investment approval process, substantially reducing provincial authority to approve large investment projects.

... And Extending Controls on External Transactions

Beijing is also turning to central controls to offset the strong international repercussions of suppressing the prodemocracy demonstrations. Since last June, foreign exchange earnings from tourism have plummeted, foreign investment commitments have slackened, and access to concessionary financing has been sharply reduced. The damage inflicted by China's image problem has been magnified by austerity measures and the slowing economy, which have reduced China's appeal to many Western investors at a time when dramatic changes in Eastern Europe have made those countries more desirable sites for investment and soft loans.

Foreign Investment. After posting an average growth rate of 30 percent a year since 1980, new foreign investment contracts increased a mere 8 percent last

Figure 5
Foreign Exchange Earnings
From Tourism



Source: Official Chinese statistics

Tourist arrivals and foreign exchange earnings from tourism plummeted sharply following last June's turmoil; losses over the last 12 months probably exceed \$1 billion. In 1989, annual tourist arrivals fell 23 percent to 24.5 million while annual tourism earnings declined 20 percent to \$1.8 billion. The first quarter of 1990 showed some improvement, in part because of increased visits by Taiwan tourists. The level of permits issued to Taiwan visitors in April, for example, was up 40 percent compared with the same month in 1989. Moreover, overall tourist levels will probably get a boost from the Asian Games, which Beijing is hosting this fall.

year, according to Chinese statistics. Foreign investment commitments reached \$5.6 billion, slightly exceeding the \$5.2 billion level reached in 1988, but primarily because commitments grew at a record pace before the demonstrations. If the rate of growth in pledged investment commitments set during the first half of the year had continued, China might have realized as much as \$8 billion in foreign investment in 1989, \$2.4 billion more than the actual amount committed. Booming investment from Taiwan—commitments in the past few years have exceeded \$1 billion—has helped keep the foreign investment totals from falling too far. During the first quarter of this year, new foreign investment contracts continued to decline; falling 42 percent to \$870 million compared with the same period a year ago.

Beijing has undertaken several measures to shore up investor confidence. Late last year, for example, Chinese officials announced that they would make the equivalent of about \$100 million in domestic credit available to foreign-invested firms experiencing financial strains and promised "emergency" supplies of raw materials to joint ventures hit hard by austerity measures. Beijing also purchased stockpiled cars from several automotive joint ventures that had seen their domestic sales deteriorate sharply after Beijing put the brakes on the availability of credit to Chinese consumers. Moreover, an amendment to China's existing joint-venture regulations adopted in early April permits foreigners for the first time to function as chairmen of joint-venture firms in China and allows the firms to operate in perpetuity. The authorities have also sanctioned 50-year land leases for development purposes and pledged not to nationalize or expropriate Sino-foreign enterprises.

International Lending. At the request of many of the countries that donate funds to international financial institutions like the World Bank and the Asian Development Bank, billions of dollars' worth of concessional financing remains on hold. Consideration of seven World Bank loans totaling \$780 million—more than one-third of planned lending for 1989—was postponed following the Tiananmen incident last year. Since

early this year, the World Bank has approved loans to China only if the project involved meets "basic human needs" criteria. For its part, the Asian Development Bank has not resumed lending to China. Although disbursements from loans signed prior to June 1989 continue, the lack of new financing—of which only about 3 percent is usually disbursed in the first year after signing—will be felt most strongly when the pipeline of previously approved funds shrinks.

Bilateral economic assistance has also slowed, delaying promised low interest development loans that are targeted primarily for energy, transportation, and telecommunications. Japan's third yen loan package of more than \$5 billion—which was due to go into effect in April—has been delayed, and West European countries have also curtailed new concessionary loans.

The suspension of official lending to China has predictably made commercial bankers more cautious. The rates on post-Tiananmen commercial loans have increased up to 1 percentage point above the London Interbank Offered Rate (LIBOR)—a marked increase from the below-LIBOR rates available to China before the unrest—and some banks have drawn down short-term revolving trade credit lines in reaction to the increased risks. The international bond market has also downgraded China's credit rating.

International Trade. To prevent a rapid drawdown of foreign exchange reserves and to protect its ability to meet its international debt servicing obligations, Beijing has tightened import controls. In the past year, the central government has reclaimed much of the foreign trade authority devolved to the provincial and local levels under reforms in the late 1980s. For example, Beijing has increased the number of goods subject to import licenses, banned imports of some products, curtailed the activities of local foreign trade companies, and reemphasized import substitution. In cases where import licenses are available, Beijing has raised tariffs, by as much as 100 percent in some cases, to prohibitive levels. Beijing has also tightened restrictions on foreign exchange use, making it more difficult to obtain required import license approvals from the banking authorities. (See appendix B for a detailed chronology of Beijing's trade recentralization measures.)

Beijing has also used increased control over the trade sector to promote exports, directing increased allocations of credit and raw materials to export-oriented enterprises. The austerity program has also helped to boost exports indirectly because the slump in domestic demand has freed up goods for export. Moreover, the increased use of export licenses has curbed the price competition among local trade companies that had caused prices of some exports to fall.

As a result of Beijing's trade controls, imports fell 7 percent during the last six months of 1989, following a 27-percent increase during the first half of the year. Paired with 11-percent growth in exports, China narrowed its trade deficit in 1989 by \$1.1 billion to \$6.6 billion, according to Chinese Customs statistics. This trend has continued in 1990; Chinese data indicate exports increased 14.6 percent through April while imports declined 17.8 percent, causing a trade surplus of \$1.3 billion.

The slowdown in imports has improved China's current account balance and boosted first-quarter 1990 foreign exchange reserves to more than \$21 billion. This augurs well for Beijing's ability to meet its foreign debt servicing obligations—which are expected to reach approximately \$4 billion annually during the period 1990-91 and peak at \$5.4 billion in 1992. Growth in China's foreign debt slowed dramatically last year, partly due to international reaction to the events of 4 June and partly due to China's reduced need for foreign borrowing during this period because of weak economic growth and an improved current account balance. Beijing borrowed \$1.3 billion last year, substantially less than the approximately \$9 billion borrowed annually in 1987 and 1988. At yearend 1989, China's foreign debt reached more than \$40 billion.

Economic Outlook

As China's leaders enter the 1990s, they face a dilemma: their top priorities are to keep a lid on social unrest—thus maintaining party control—and to convince foreign bankers, investors, and China's trading

partners that life has returned to normal. But they probably cannot meet these objectives over the long run without returning to the reforms abandoned in the past several years, which relied on decentralizing decisionmaking authority. Their short-term solution evidently is to ease credit gradually while extending central controls to keep inflation in check.

Such a policy, however, contains no lasting solutions to China's problems of economic instability. Industrial efficiency almost certainly will remain depressed because the expanded scope of central planning is likely to erode incentives by reducing managerial autonomy and forcing factories to sell goods at low, state-set prices. Equally important, the increased allocation of raw materials and energy inputs to large state enterprises will further squeeze the dynamic nonstate sector, hampering its integral contribution to economic growth—providing inputs for state enterprises, producing goods for export, and absorbing labor from the oversaturated agricultural sector. Beijing's strategy of merging essentially bankrupt companies—with their bloated work forces—with healthy enterprises is likely to introduce an additional drag on efficient production. Thus, large state enterprises will not become engines of growth for the economy. Moreover, increased price and enterprise subsidies, combined with slower growth in state revenues, probably will increase the budget deficit.

If intensified government support to large state enterprises does not produce quick results, political pressures may force Beijing to open the credit spigot wider. Because China is resource rich, such a move would spur growth, but, without market-oriented reforms, easier credit alone will not improve the efficiency of investment, and increased aggregate demand will worsen China's energy and transportation bottlenecks. Indeed, policies of the past 20 months have treated the symptoms rather than the causes of China's overheating-prone economy, raising the specter of renewed inflation and a return to the boom-bust cycles that have plagued China's economy for the past decade. Moreover, because China's macroeconomic management techniques are inexact and the economy responds with a lag to credit changes, Beijing might not know the economy is overheating until it is too late to take corrective action. The large overhang of

personal savings contributes to the likelihood of a renewed surge in inflation; once prices start to rise, people will quickly withdraw savings and purchase consumer goods.

As for the prospects for a return to reform policies, Beijing recently has been taking a softer line, probably in part to ease Western economic sanctions. For example, Beijing has reiterated its support for the Special Economic Zones (SEZ) in southern China and recently approved Shanghai's Pudong district for preferential treatment to encourage foreign advanced technology investments and spur economic growth. The official Chinese press has also announced approval for opening China's first futures market—for wheat—with eventual expansion for others for rice, corn, and pork. Press accounts also have discussed opening a stock market in the Shenzhen SEZ and development of experimental securities exchanges in Shanghai and Shenzhen. In addition, Beijing has announced increases in state-controlled prices of some raw materials and agricultural products.

The prospects for return in the near term to comprehensive, market-oriented reform, nevertheless, appear dim. Political support for reform has been weakened by leadership squabbling and the removal of two reform-minded party general secretaries in the past three years. Although it is unlikely that many senior officials want to return to the command economy and isolationist policies that dominated China before 1979, there are those in the leadership who want to place strict limits on the development of the nonstate sector and to increase the party's role in enterprise management. Economic policy will probably be dominated by stopgap measures aimed at ensuring stability rather than by longer term strategies for growth and development. (See appendix C for a detailed analysis of the underlying causes of China's economic instability.)

The inability to proceed with comprehensive, market-oriented reforms could slow Beijing's efforts to rebuild economic ties to the West, dimming China's long-term development prospects and widening the economic gulf between China and its market-oriented

The Status of China's Reforms

Beijing's recent softening of its economic policies must be viewed in the context of a significant regression of economic reform since 1988:

- *Prices. Reform remains on hold, and controls on prices of consumer necessities and industrial goods have been tightened.*
 - *Banking. Reform has been reversed as decisions based on political objectives are carried out by administrative fiat rather than by using economic efficiency criteria. Tight credit policies have damaged other reforms, including efforts to develop interbank loan markets.*
 - *Enterprises. The contract responsibility system—which gives managers greater autonomy in return for their promises to deliver specified amounts of output and taxes—remains in place, but Beijing is attempting to exert greater control over the industrial sector through increased mandatory planning and control over inputs and output.*
 - *Bankruptcy. Beijing's unwillingness to allow enterprise bankruptcies continues to inflict a drag on the economy and is ratcheting up subsidies.*
 - *Rural enterprises. Beijing is beginning to ease its hard line against this sector, recognizing its role as a significant absorber of surplus rural labor, but has reiterated its determination to limit growth rates to half the levels realized in the late 1980s.*
 - *Agriculture. The household-based responsibility system—which gives peasants control over cropping choices and earnings in return for deliveries of contracted amounts of grain to the state—remains in place due to strong grassroots support for this early and successful reform. Beijing, however, is attempting to use increased planning and stricter contract enforcement to boost output.*
 - *Foreign trade. Beijing is continuing to recentralize control over trading authority and foreign exchange use to ensure it can meet payments due on its foreign debt.*
-

East Asian neighbors. The continued slower pace of foreign investment will impede Beijing's ability to acquire needed foreign exchange as well as foreign marketing and management skills. Moreover, although Beijing has been able to adjust during the past year to the downturn in economic relations with the West, failure to proceed with reform could slow lending by international financial institutions, even if formal economic sanctions are lifted. This could delay

progress on China's long-term modernization goals as decreased access to low-cost financing impairs its ability to gain technological know-how through high-tech joint ventures or to import advanced technology. A continued decline in capital goods and raw material imports will also stifle the pace of China's economic development.

Appendix A

Economic Performance in 1989 and 1990 by Sector

Industrial Performance

After expanding at a breakneck pace of nearly 17 percent in 1988, China's industrial growth slowed to 7 percent last year. The output of state-owned industries slowed to less than 4-percent growth in 1989, while the collective sector—including township and village-run industries—grew almost 11 percent and the private sector increased 24 percent. Foreign-funded enterprises posted a 45-percent gain in output value in 1989.

Industrial production increased 1.5 percent during the first five months of this year, compared with the same period a year ago. The credit infusion begun late last year has started to stimulate production modestly—output grew at a 4-percent annual rate in May—but consumption remains sluggish, the growth rate of the once vibrant rural industrial sector has dropped sharply, and production of large state-run enterprises remains sluggish.

Agriculture and the Rural Economy

China's agricultural output increased about 3 percent in real terms in 1989. Grain production grew 3 percent to reach 407 million metric tons, matching 1984's record performance, as a result of an 18-percent increase in procurement prices and favorable weather. The total, however, was still 5 million metric tons short of target. As a result, China imported nearly 17 million metric tons of grain—primarily from the United States, Australia, the European Community, and Canada. Meanwhile, the output of other agricultural staples, such as cotton and oil- and sugar-bearing crops, declined because low producer prices prompted peasants to reduce acreage for these crops.

China's rural industrial sector was hit hard last year by centrally mandated cutbacks in credit, energy, and raw materials. In addition, some local authorities reacted to Beijing's edicts to slow rural industrial growth by increasing taxes on rural factories, imposing strict capital requirements for an operating

Table 1
China's Balance of Payments, 1985-89

Billion US \$

	1985	1986	1987	1988	1989
Current account	-11.4	-7.0	0.3	-3.8	-4.3
Trade balance	-13.1	-9.1	-1.7	-5.3	-5.6
Exports	25.1	25.8	34.7	41.0	43.2
Imports	38.2	34.9	36.4	46.4	48.8
Nontrade income (net)	1.5	1.7	1.7	1.1	0.9
Unrequited transfers (net)	0.2	0.4	0.2	0.4	0.4
Capital account	9.0	5.9	6.0	7.1	3.7
Long-term capital (net)	6.7	8.2	5.8	7.1	5.4
Short-term capital (net)	2.3	-2.3	0.2	0.1	-1.5
Change in reserve assets	-2.4	-1.3	6.3	3.3	-0.5

Notes: 1. Change in reserve assets: in this table, contrary to standard practice, a negative number denotes a drawdown in foreign exchange reserves; a positive number indicates an addition to foreign exchange reserves.

2. Merchandise trade data are based on Customs statistics, adjusted in accordance with balance-of-payments specifications.

3. Nontrade income includes shipment fees, tourist revenues, investment income, labor contracts, and other nontrade services.

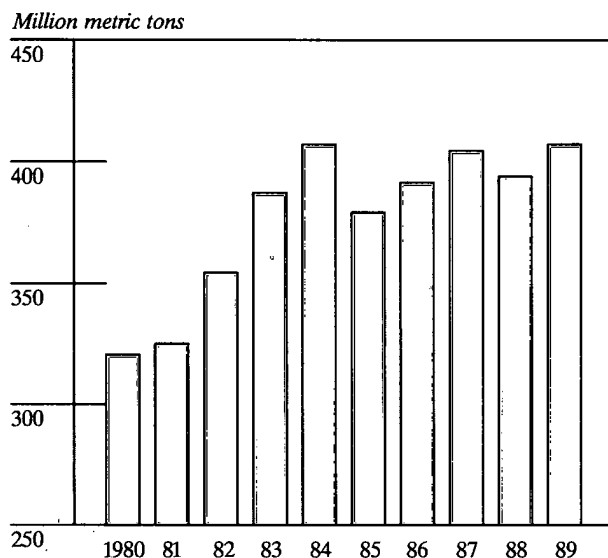
4. Official unrequited transfers include grants and donations to and from international organizations and foreign governments; private transfers include remittances and payments from abroad by residents.

5. Long-term capital carries a maturity of one year or longer. It includes foreign direct investment; portfolio investment; international organization and foreign government loans; loans to PRC banks, government agencies, and localities; deferred payments and collections; processing, compensatory trade and leasing payments; PRC loans abroad; and other long-term capital.

6. Short-term capital includes loans to PRC banks, government agencies, and localities; deferred payments and collections; and other capital to be repaid within one year.

license, and tightening restrictions on employment by prohibiting factories from hiring workers who do not meet local residency requirements. One of the fastest growing sectors in China's economy, these firms have accounted for more than half the value of rural output since 1987 and employ 85 million workers, about 15

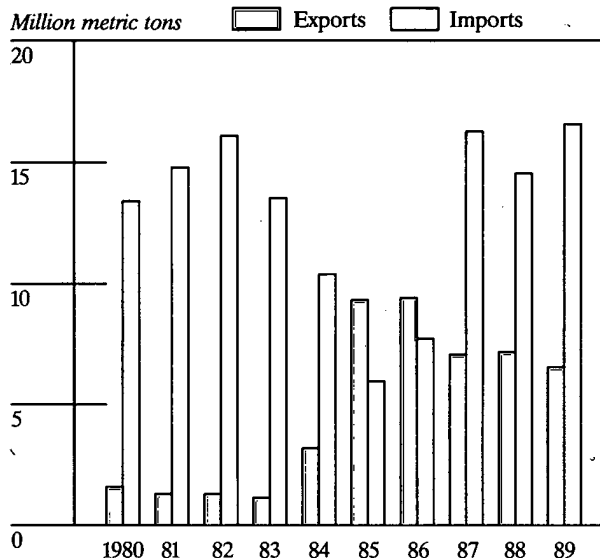
Figure 6
Grain Production



Source: Official Chinese statistics.

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Figure 7
Chinese Grain Trade



Source: Official Chinese statistics

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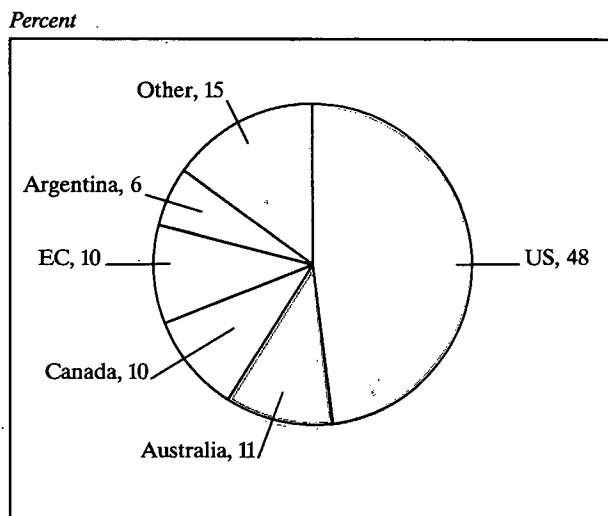
percent of China's labor force. Some municipal leaders have tried to soften the impact of austerity measures by defying orders from higher authorities to cut energy and raw material supplies to local factories, and workers and managers in some rural enterprises have pooled their personal savings to keep their factories going. These efforts have had only a limited impact, however; the output from rural enterprises slowed to only 8 percent in real terms last year, about one-fourth the rate in 1988.

Agricultural policies for 1990 are focusing on correcting last year's trouble spots. To motivate peasants to increase production of nongrain agricultural staples, Beijing announced it would raise the purchase prices of government-contracted cotton, oilseeds, and sugar crops. Beijing opted not to increase the purchase prices of grain this year, however, because of the good

1989 harvest and because of its strained budget. Beijing is continuing to recentralize distribution of fertilizer, pesticides, and the plastic sheeting that peasants use as mulch and plans to increase state investment in agriculture by about 30 percent.

Beijing will continue to tinker with reform experiments in a few areas. For example, Beijing reportedly gave the go-ahead in early June to open the country's first futures market—for wheat—and announced plans to establish others for rice, corn, and pork. In general, however, China's planning-oriented leadership will try this year to boost output by administrative methods, rather than by strengthening the role of markets.

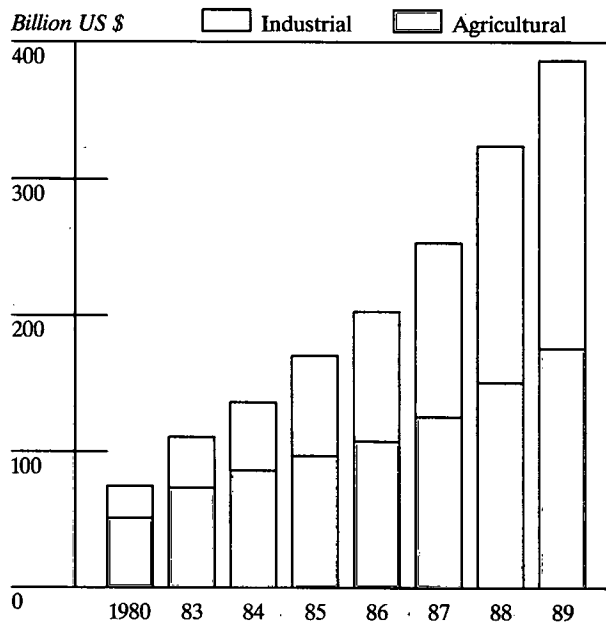
Figure 8
Major Grain Suppliers, 1989^a



^aCalculated by value of imports.
Source: Chinese Customs statistics

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Figure 9
Gross Value of Rural Output^a



^aData not available for 1981 and 1982.

Source: Official Chinese statistics

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The leadership has toned down its rhetoric on rural enterprises since March. The Chinese press reported in February, however, that Beijing will incorporate rural enterprises in its state plan this year to ensure that energy, capital, and raw materials are more fairly allocated to state-run firms. Moreover, Chinese officials have announced that no new rural enterprises will be allowed to open over the next two or three years except those producing goods for agriculture or export or those supplying energy or necessary consumer goods.

US-China Trade

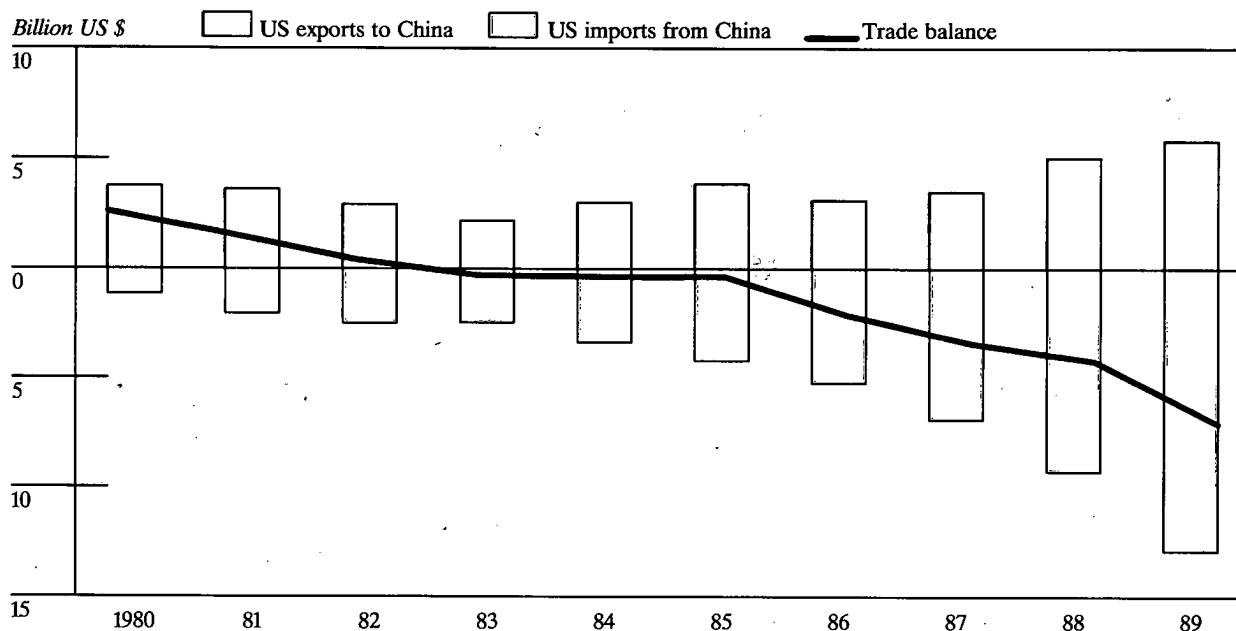
The United States became China's primary export market last year following a 39-percent surge in sales to the US market. Beijing's austerity program and tighter import controls, however, slowed growth in US sales to China by almost two-thirds from the robust pace achieved in 1988. Consequently, the US trade deficit with China almost doubled to over \$7 billion in 1989, according to US Commerce Department

statistics.³ The US deficit with China could exceed \$10 billion this year; US statistics indicate China's exports to the United States increased at a 36-percent annual rate during the first three months of 1990.

The surge in Chinese exports to the United States reflected China's overall export push in the second half of 1989—including increased state allocations of credit and raw materials to the export sector—as well

³ China's Customs statistics differ considerably from those recorded by the US Commerce Department. Chinese statistics indicate that exports to the United States last year totaled \$4.4 billion while its imports equaled almost \$7.9 billion, giving China a bilateral deficit of about \$3.5 billion, rather than a surplus of \$7 billion. A major reason for the discrepancy is that the United States tallies all goods shipped to and from China, regardless of whether they are shipped directly or through third parties such as Hong Kong; China only includes direct shipments. For a more detailed discussion of the discrepancy, see EA 88-10018 (May 1988), *China: Economic Performance in 1987 and Outlook for 1988*, report to the Joint Economic Committee of Congress.

Figure 10
US-China Trade, 1980-89



Source: US Commerce Department

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as China's targeting of the US market. Chinese exports of labor-intensive manufactured goods such as televisions, stereo equipment, footwear, toys, and household appliances continue to post substantial gains in the US market. China's low wages have made it extremely competitive in these product lines, which have been the focal points for domestic and international investment. Clothing exports, which accounted for almost one-fourth of US purchases from China, expanded as Chinese apparel producers continued their move into higher quality and higher priced articles. Moreover, tighter controls over the trade sector prevented Chinese trading companies from exporting unprocessed silk, cotton, and wool, which had hampered growth in textile production in 1988.

Some US exporters, on the other hand, were hurt by import licensing restrictions Beijing imposed to control foreign exchange outflows. US sales of wood products, for example, fell 60 percent last year after Beijing decided in March to adopt an import quota system for timber purchases. Even in instances where import licenses have been granted, however, cutbacks in credit from state banks have forced Chinese trading companies to curtail purchases of foreign goods. Exports of some US products, including textile fibers and iron and steel, grew substantially because of domestic Chinese shortages of these goods. Grain and

Table 2
Selected US Imports From China, 1989 ^a

	Value (million US \$)	Share of Total (percent)	Growth Over 1988 (percent)
Total US imports	12,091.0	100	39
Clothing	3,115.9	24	41
Toys, sporting goods	1,510.8	12	47
Telecommunications equipment	1,087.9	8	106
Footwear	770.0	6	106
Textile yarns, fabric	653.4	5	8
Travel goods, handbags	591.6	5	28
Petroleum	558.7	4	12
Household electrical appliances	411.8	3	49
Metal manufactures	347.0	3	40
Shellfish, seafood	316.9	2	-4

^a Imports calculated cost, insurance, and freight (c.i.f.).

Source: US Commerce Department.

agricultural-related exports also increased, reflecting Beijing's concerns about that crucial sector. Because of Beijing's increased emphasis on energy and infrastructure development, US sales of transportation equipment and power generators also increased.

Sino-Soviet Economic Relations

Sino-Soviet trade grew about 23 percent in 1989 to reach \$4.0 billion, with Beijing posting a nearly \$300 million deficit. Modest growth in centrally planned trade was overshadowed by expansive growth in outside-of-plan trade along the Sino-Soviet border, which now accounts for 19 percent of overall trade, nearly doubling the share in 1988. More than 75 percent of China's imports from the Soviet Union last year were raw materials—including fertilizer, timber, iron, and steel—and transportation equipment. Chinese exports of textiles and foodstuffs continue to dominate sales to

Table 3
Selected US Exports to China, 1989 ^a

	Value (million US \$)	Share of Total (percent)	Growth Over 1988 (percent)
Total US exports	5,807.4	100	15
Grain	1,126.6	19	61
Aircraft	536.2	9	60
Fertilizers	487.4	8	168
Specialized machinery	361.3	6	10
Textile fibers	355.1	6	253
Organic chemicals	286.6	5	2
Iron and steel	244.4	4	299
Power-generating equipment	201.7	3	42
Plastics, resins	197.5	3	-66
Wood products	179.1	3	-60

^a Exports calculated free alongside ship (f.a.s.).

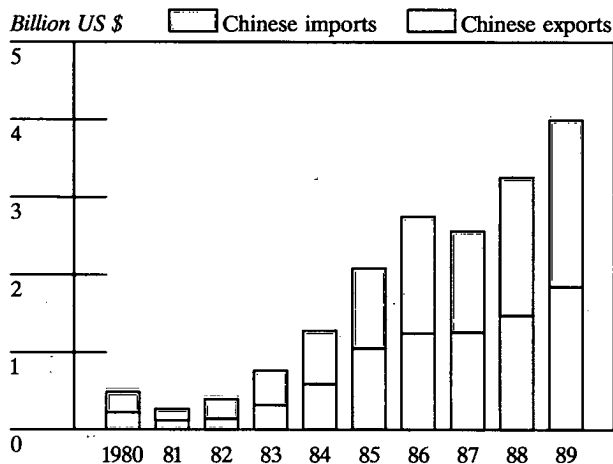
Source: US Commerce Department.

the Soviet Union, but exports of automatic data-processing and office equipment posted nearly a nine-fold increase over 1988 levels.

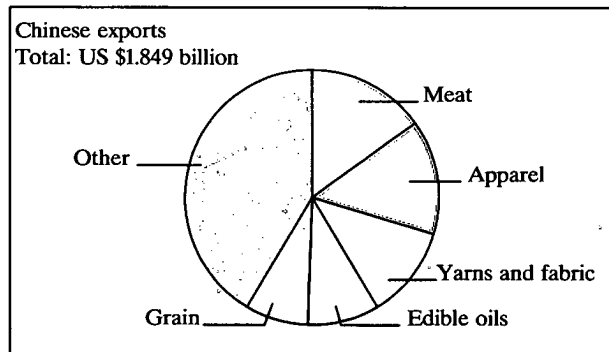
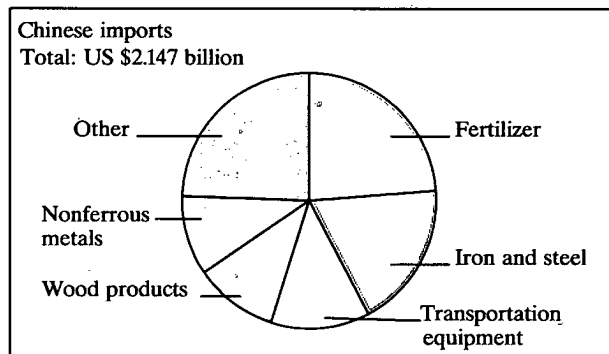
Beijing's attempts to expand Sino-Soviet economic relations following the Tiananmen incident and the dramatic changes in the Soviet Union last year were highlighted during the visit of Chinese Premier Li Peng to Moscow in April 1990. Premier Li signed several protocols including:

- A 10-year framework agreement governing the development of economic, scientific, and technological cooperation.

Figure 11
Sino-Soviet Trade



Commodity Composition in 1989



Source: Chinese Customs statistics

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- An agreement to provide the Soviet Union with trade credits valued at nearly \$336 million to purchase Chinese textiles and light industrial products; Beijing had refused to consider such an arrangement in earlier protocols.
- An intergovernmental memorandum on plans to cooperate in building two nuclear power stations in China using Soviet technology and equipment, repayable over the course of several years with Chinese consumer goods.

The growth in Sino-Soviet trade nevertheless is likely to slow in 1990, and serious challenges to the economic relationship lie ahead. Border trade began to encounter problems in the second half of 1989 after Moscow began restricting exports of many of the raw materials that have been the foundation of that trade, such as timber and steel, for use in its own economic development drive. As a result, although Soviet interest in Chinese consumer goods remains high, Chinese traders find little to their liking among the remaining available Soviet goods. Trade could decline, moreover, if Moscow and Beijing proceed with a plan currently under discussion to move away from barter exchanges to hard currency trade beginning next year.

The Taiwan Connection

Despite Taipei's official policy banning direct trade with, and investment in, China, economic ties between Taiwan and China are increasing at a remarkable rate. Cross-straits trade increased by two-thirds during the first six months of last year, followed by a sharp slowdown during the second half of the year as Beijing tightened austerity measures. Overall, bilateral trade posted a 29-percent increase in 1989 to \$3.5 billion. Taiwan registered a \$2.3 billion surplus for the year, primarily exporting machinery, electronics, and plastics in exchange for agricultural raw materials and herbal medicines. Moreover, Taiwan firms signed investment commitments worth between \$500-600 million last year—topping their 1988 total of \$400 million—primarily for labor-intensive, export-oriented ventures producing clothing, shoes, umbrellas, and toys. Preliminary statistics also indicate that, during the first four months of this year, Taiwan investment commitments in China were between \$400-500 million.

The economic value of commercial ties is likely to grow over time despite political tensions across the strait because neither Taiwan nor China wants to sacrifice the benefits of trade and investment. Taiwan receives favorable tariff treatment, giving its exports a competitive edge. More important, the growing number of Taiwan-invested enterprises in China will purchase an increasing volume of Taiwan-made components, which will also boost Taipei's exports. Investments in China will probably continue to attract a growing number of Taiwan businessmen looking to avoid the labor shortages, high wages, and environmental restrictions at home.

The State Budget and Spending Priorities

China's government budget deficit grew about 40 percent in 1989 to reach almost \$8 billion. Although revenues exceeded original targets as Beijing intensified tax collection efforts, expenditures soared. Subsidies for enterprise losses, for example, increased to \$12.7 billion, a 35-percent jump over 1988 and 15 percentage points above the budgeted increase. Beijing financed the deficit by issuing domestic bonds and borrowing from abroad.

Although China's deficit is low by international standards—about 2.4 percent of GNP in 1989—Beijing is concerned about its rapid rise. Moreover, many in the orthodox leadership view any government deficit as an indication of economic mismanagement and could use it as an additional argument for holding off on market-oriented reforms. Indeed, Beijing began pushing last year to reclaim some of the financial autonomy given to provincial and local governments in the 1980s.

China's 1990 budget calls for a 14-percent increase in the deficit as slower economic growth prevents revenues from increasing significantly and as expenditures for key capital construction projects, defense, and

subsidies grow. The 1990 budget projects that one-third of this year's expenditures will go to subsidies, but that share could grow if China's industrial sector does not rebound soon.

Defense Spending

Beijing has announced that it will increase state funding for the military this year by more than 15 percent to 29 billion yuan (slightly more than \$6 billion). This will be the first real increase in the announced defense budget in six years. Actual Chinese defense spending, however, will probably be twice the announced figure. Although state-allocated funds are the single largest source of revenue for the military, other sources of funding—including profits from arms sales and the earnings of several thousand military-run commercial enterprises—total several billion dollars annually. Moreover, a large portion of the military's research and development costs are subsidized by state-run research institutes or paid out of funds earmarked for civilian organizations. The military also supplements its living expenses through sideline production of agricultural commodities such as grain, vegetables, and meat.

The Chinese military will probably allocate some of this year's increase in defense spending to military pay and allowances to bolster troops' morale and improve living standards, which have been hurt following several years of double-digit inflation. A significant portion of the increase in defense spending this year probably will also go to purchasing new equipment, such as riot control gear for military rapid-reaction units, and repaying the operational costs incurred by the military in enforcing martial law in Beijing and Lhasa during 1989.

Appendix B

Chronology: Beijing Recentralizes Control Over Trade Sector

15 September 1988	Customs duties doubled on imports of consumer appliances—such as washing machines, radios, and cassette players—to 100 percent.
22 September 1988	Control over silk imports and exports recentralized.
1 January 1989	Exports of copper, nickel, aluminum, platinum, yellow phosphorus, and their alloys banned. Sixteen items added to the list of commodities that require export licenses: newsprint paper, bone dust, polystyrene, polypropylene, ABS resin, chromium ore, molybdenum ore, ferrochrome, ferromanganese, magnesium metal, manganese metal, methylbenzene, dimethylbenzene, rubber, salted pine mushrooms, and Chinese medicinal herbs.
14 January 1989	Trade and distribution of cellulose acetate filter tips used in manufacturing cigarettes recentralized under state trading corporation; import licenses now required for these items.
25 January 1989	Import and Export Permit Administration established to tighten control over the granting of import and export licenses.
1 February 1989	Control over pesticides production and sales recentralized.
20 February 1989	Imports of foreign cigarettes and liquor banned.
19 March 1989	Imports of timber cut 40 percent and managed under a new quota system; quotas allocated to local governments, which then determine what kind of timber they wish to buy.
6 April 1989	Imports of all luxury cars banned. Moratorium imposed on import licenses for canned beverages; additional joint ventures producing canned beverages not authorized.

1 May 1989	Quality licenses required for imported products that involve safety, public health, and environmental protection, including automobiles, motorcycles, motorcycle engines, refrigerators, refrigerator compressors, air conditioners, air-conditioner compressors, color television sets, and kinescopes.
15 May 1989	Guangdong Province banned imports of cigarettes, alcohol, cosmetics, canned foods, frozen fish, meat, fruit, candies, biscuits, vegetables, clothing, shoes, scented soap, shampoo, beverages, household electrical appliances, and plastic daily essentials.
1 June 1989	Plywood import coordination group composed of nine corporations with the exclusive right to import plywood created. Only three of the nine allowed to participate in price negotiations.
10 June 1989	Export licenses—with approval granted by one of two central bodies—required for six metal ores: copper, zinc, lead, manganese, iron, and nickel.
13 July 1989	Central management extended to 13 kinds of imports, including grains, sugar, steel, fertilizers, crude and refined oil, rubber, timber, polyester fibers, tobacco, cotton, pesticides, and farm use film. Controls tightened over imports of wool, wood pulp, plywood, craft paper, corrugated paper, chemical materials, scrap ships, and television tubes.
27 July 1989	Wool import coordination group created to further recentralize wool imports and unify decisionmaking. Forty-percent tariff on imports of materials used in the production of pop top cans imposed to further recentralize imports of canned drinks. Government institutions, mass organizations, and enterprises prohibited from using public funds to purchase canned drinks.
1 August 1989	Import of 20 electronic and machinery products and some associated assembly lines banned, including hi-fi components, videocassette recorders, televisions, computer hardware, and radiocassette tape recorders.
4 August 1989	One hundred and six goods in 44 different categories added to the list of items subject to inspection.

11 August 1989	Import duties on six items increased: coffee, syrup, vacuum cleaners, electronic games, cosmetics, and soap. Export duty rates raised 50 percent on lead and zinc exports.
28 August 1989	Inspection guidelines imposed for television imports, based on new standards.
1 September 1989	Tariff levels for various imports increased: imports of medical instruments, scientific research apparatus, medicines, drugs, and perfumes subject to 20-percent tariffs; household appliances, cameras, watches, bicycles, textile products, and cosmetics assessed 100-percent duties; imports of videocassette recorders and motorcycles given 150-percent duties; cigarettes, liquor, and limousines assessed at 200 percent.
26 October 1989	Guangdong Province established "coordinated prices"—minimum export prices—for 29 goods, including lithopone, yuanming powder, potassium permanganate, cassia, cassia oil, paper products, cattle hides, feather and down, rattan products, black wood furniture, red bricks, sea sand, freshwater sand, canned fish, soy sauce, lychee, mandarin oranges, shelled peanuts, sesame, dried rice vermicelli, blanched peanuts, electric fans, fluorescent lamp stands, glazed wall tiles, pocket knives, padlocks, plastic products, mosaic, and precious ink stone.
28 November 1989	Exports of tungsten centralized, giving sole trading rights to three corporations.
13 February 1990	New import restrictions approved on building materials such as marble, granite plates, certain types of glass, plastic carpeting, plastics, glass fiber, flax or cotton wallpaper, wall or floor bricks, plaster stone plates, and aluminum alloy doors and windows.
13 April 1990	Exports of paraffin wax recentralized.
15 May 1990	Review of electric power generating equipment imports tightened.

Appendix C

Interpreting China's Economic Instability

The Dilemma of Stopping Halfway

Much of China's economic instability is due to the incomplete nature of industrial reforms. During the past decade, for example, Beijing steadily increased the share of revenues that state enterprises and local governments could retain and gave them greater latitude over how funds were spent. Indeed, retained earnings of state enterprises were eight times larger in 1988 than when reforms began, according to the Chinese press. But Beijing did not implement meaningful bankruptcy measures, and without any such market-oriented control mechanism, many factory managers took advantage of increased decisionmaking autonomy to expand investment spending and worker remuneration without regard to efficiency. Consequently, during the 1980s, investment spending soared more than 20 percent a year, and real wages of state industrial workers outpaced labor productivity.

Beijing's failure to complete price reforms is also central to China's economic difficulties. Although the authorities have taken tentative steps to ease irrationalities in China's pricing structure—including raising state procurement prices for grain, decontrolling prices of nonstaples and many consumer durables, and allowing sales of overquota industrial products at market prices—prices of energy and key raw materials are still held artificially low. Because raw materials are cheap, manufacturing industries can generally make profits even if factories use inefficient, outmoded equipment. This has encouraged local officials to use their increased revenues to invest in manufacturing industries, which has increased the demand on chronically short supplies of energy and raw materials. The inflationary consequences of these moves were temporarily offset in the early 1980s by reform-driven efficiency gains in key sectors. For example, between 1981 and 1984 production of grain and cotton increased about 8 percent and 28 percent, respectively, because Beijing hiked procurement prices and allowed peasants to retain profits from overquota production. This helped Beijing meet rising consumer demands for food and clothing caused by

urban wage increases. Hikes in coal prices and policies allowing individuals and local governments to open their own mines caused coal output to grow 8 percent a year during the same period, allowing power plants to generate increased amounts of electricity, which contributed to rapid industrial growth, particularly by locally run firms manufacturing consumer items. The production gains from breaking up the communes were exhausted by 1985, however, and the gains from opening individual mines also began to taper off during the latter half of the 1980s. Inflation, accordingly, picked up later in the decade. The inflation rate tripled in 1985 to almost 9 percent, pushed along by decontrol of nonstaples prices and by a rapid increase in the money supply that was caused by moves the previous year to decentralize the banking system. After remaining at the new plateau for two years, inflation more than doubled in 1988 and reached a record 27 percent in early 1989.

China's reformers had expected a rocky transition from a planned economy to a more market-oriented system, but inflation of that magnitude was probably unanticipated, and it undermined their ability to pursue market-oriented solutions. Articles in Chinese journals indicate that, since at least the mid-1980s, some Chinese economists correctly understood why partial market reforms caused inflation and other economic dislocations. But rising prices and declining efficiency sharply split reformers over the appropriate pace and sequence of additional market measures.

The Role of Regional-Center Tensions

Another key element in China's economic instability is the inability of Beijing and the provinces to concur on a division of responsibility for economic management. Since orthodox leaders took control of China's policy agenda in late 1988, they have tried to reclaim financial and planning authority from local levels and

to increase government support to key state enterprises that produce energy and raw materials. Although austerity policies have dampened growth, efforts to recentralize the economy have been resisted by municipal and provincial officials, who have strong cards to play when they bargain with central authorities for control of finances:

- Local governments control a significant share of industrial production. In 1988 locally run enterprises produced more than one-third of China's industrial output, up from one-fifth a decade ago, according to official statistics. Moreover, they control important sources of raw materials; more than 50 percent of coal was produced by locally run mines in 1988, and about half of China's steel and more than four-fifths of its cement were produced outside Beijing's central plan.
- Provincial and municipal governments are important sources of foreign exchange. The freer economic rein that Beijing has given provinces, particularly along China's southern coast, is a key reason that these local governments have rapidly built up export industries and attracted foreign investment. Indeed, over the past 10 years Guangdong Province has been the recipient of about half of the total foreign investment in China, and in 1989 it accounted for 15 percent of the country's exports. In addition, locally run firms throughout China have become important sources of foreign exchange. For example, rural enterprises in 1989 exported more than \$10 billion of goods, about 19 percent of China's total, according to the Chinese press.
- Beijing depends on local governments to implement its policies. Almost all tax collectors, for example, are appointed and controlled by local officials. The Chinese press has cited numerous examples of local governments arbitrarily exempting enterprises from taxes or simply refusing to collect particular types of taxes. Municipal officials also set prices of locally produced goods and appoint most of China's price inspectors. Chinese media have reported that local officials often authorize price hikes—despite central government edicts to freeze prices—because they increase enterprise profitability and tax receipts.

The Resulting Policy Paradox

Beijing's meat-ax approach to austerity is causing economic dislocations that will raise the political cost of sustaining austerity and undermine the credibility of current policies. Indeed, as inflation falls, it will undercut the arguments of planners that the costs of keeping the clamps on the economy are justified. If inflation stays in single digits in 1990, reformers—including many local officials—may successfully argue that the greatest danger of renewed social unrest is from slow growth, rising unemployment, and falling standards of living. On the other hand, China's current mix of planning and decentralized decision-making makes it likely that inflation will reemerge when Beijing eases austerity measures. That will make it difficult for any reform leaders to decontrol prices and press ahead with market measures such as bankruptcy that are necessary to alleviate China's economic imbalances. At best, these measures would require years to implement, and the leadership would have to be willing to accept the decrease in party control that they would entail. Thus, policy may vacillate between austerity and expansion, and economic problems will widen differences in the leadership, as they have since the mid-1980s.

Municipal and provincial governments will probably be able to sustain their economic power over time. In the next expansion phase, locally run industries will probably outpace state enterprises as they have for the last decade, which will increase the share of the economy outside central control and increase the clout of localities. Moreover, the pressure to protect local industries during retrenchment periods will cause China's economy to become increasingly fragmented into protected local markets. Corruption will continue to grow, particularly during expansion phases as officials try to make as much money as they can before Beijing starts backpedaling again.

Signposts for Improved Macroeconomic Control

The transition to stable growth will require policies that produce a stream of efficiency gains and give Beijing indirect means to control the pace of renewed

economic activity. One way to do this would be to reduce the share of the economy subject to central planning and make the state-controlled sector face increased market pressures. Beijing could take important strides toward eliminating price distortions in the economy by continuing to reduce the quotas of goods, particularly raw materials and industrial inputs, that state factories must supply within the central plan. Because overquota production can be sold on the market, this would gradually increase the share of key goods sold at market prices and provide incentives for increased efficiency in state factories that buy and sell these goods. Enforcement of bankruptcy regulations, even if applied cautiously, would also spur more efficient use of raw materials and finances by state factories. The development of a comprehensive unemployment-compensation system would make enterprise bankruptcy politically easier to carry out because state factory workers currently stand to lose housing, health care, education, and pensions if factories are shut down. Enterprise accountability could also be increased in the state sector by allowing workers to purchase shares in their factories, which would reduce dependence on government funding while tying worker remuneration more closely to factory performance.

Another way Beijing could increase market accountability would be by encouraging the expansion of the private sector. An important step would be allowing peasants to own and sell farmland. This would spur greater agricultural output by providing incentives for increased investment by peasants. It also would allow productive peasants to increase their landholdings and their use of mechanized farming methods and would free up additional workers for rural industries, which are more responsive to market forces than state factories. In addition, Beijing could continue to sell small state enterprises to private bidders.

Beijing could also improve efficiency by increasing competition between state- and locally run factories. Necessary ingredients would include development and enforcement of commercial codes that prohibit trade barriers set up by municipal officials to protect local industries. In the near term, Beijing could circumvent trade barriers somewhat by allowing factories to play a direct role in international commerce. Former party chief Zhao Ziyang's coastal development strategy apparently was designed to do this. It allowed industries in coastal provinces greater autonomy to import raw materials for processing into export goods, forcing these factories to buy and sell products at world prices and to compete with international firms.

To improve Beijing's ability to carry out monetary and fiscal policies, authorities must implement widespread financial reforms. In particular, Beijing must create an independent central bank manned by professional managers appointed by central authorities. Beijing also must create financial markets that tie local bank branches into a nationwide network. Such a nationwide financial market would allow greater competition between local bank branches and force them to be accountable for their lending decisions. In addition, Beijing will not be able to use fiscal policies effectively until it eliminates the enterprise contract system that allows tax rates to be set through negotiation between enterprises and their supervisory bureaus, rather than by central authorities.